

Sarbanes-Oxley: Two Years of Market and Investor Recovery

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before the

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Good Morning. Chairman Oxley, Ranking Member Frank and Members of the Committee, I am Mitch Caplan, Chief Executive Officer of E*TRADE Financial.

E*TRADE Financial is a leading provider of online personalized and fully integrated financial services including investing, banking, lending, planning and advice.

I would like to thank Chairman Oxley, Ranking Member Frank and the Committee for inviting us to share our company's experience with the implementation of the Sarbanes-Oxley Act as your Committee examines the law's effectiveness since its enactment two years ago.

Background

E*TRADE Financial was founded in Silicon Valley twenty years ago on the proposition that technology, properly applied, could revolutionize and democratize the financial services industry. E*TRADE has invested over a billion dollars in the development of its technology and its brand, establishing itself as a champion of the average American investor. In order to do that, it was essential that E*TRADE earn and

maintain the trust of its customers, its employees, its shareholders and the marketplace at large. The investment paid off. Our business boomed through the “dot-com” era.

Having revolutionized the brokerage industry, E*TRADE turned its attention to other aspects of financial services. With the acquisition of Telebank in 2000, the company began offering an array of online banking products and services. The company also began offering its own proprietary mutual funds in addition to a mutual fund supermarket. In 2001, the company became the third largest provider of online mortgages. In 2002, the company enhanced its proprietary trading platform for active investors and offered a broader array of consumer financing products, including automobile, boat and recreational vehicle loans. E*TRADE brought down costs and made sophisticated financial products and services more accessible to the average investor.

E*TRADE’s work as a customer champion was put at risk in 2002. As the public became increasingly leery of all decisions being made by major corporations on their behalf, our shareholders raised serious concerns about the compensation package granted to the CEO. The company’s annual proxy disclosed the total value of the CEO’s package and immediately made E*TRADE a prime example of the discrepancy between executive management rewards and shareholder value. The total value of the CEO compensation package as compared to shareholder value had not been thoroughly considered by the company’s board as a whole and as such revealed clear flaws in our corporate governance policies and structures.

Corporate Reforms

1) *Increased Board Independence*

Working closely with counsel, our Board undertook a thorough review of all corporate governance practices. The Board created the position of Lead Director to organize and lead regular meetings of the Board without the presence of any management, including the CEO. These meetings of independent board members and outside counsel, and the free and open dialogue they promoted, formed the genesis of much of the change in the Company's corporate governance practices.

2) *Board Structure and Composition*

The Board continues to find great value in this independent dialogue; so much so that they separated the positions of CEO and Chairman when I was appointed as CEO.

The Board also looked closely at its own composition. With its new CEO in place, the Board worked with outside counsel and third party advisors to examine the strengths and weaknesses of each Board member and the Company's management team. We developed a "profile" of our ideal Board candidates in the context of the requirements of Sarbanes-Oxley, the Corporate Governance Guidelines of the New York Stock Exchange, and the needs of our business.

We initially identified over forty candidates who were both qualified and interested in serving on our Board. The available pool of candidates was so strong we retained four new Board members, rather than the two we had originally sought to recruit. The new Board members bring a wealth of experience and perspective to our Board.

These new Board members participated in a rigorous new director orientation program. This program provided new directors an overview of the company's various

lines of business, its corporate and management organizational structure, human resource policies and practices as well as a detailed discussion of the legal and business obligations of directors, including a review of the Company's insider trading policies and Code of Professional Conduct.

We consolidated and centralized the work of the various committees of the Board so all board members would fully understand and participate in the Board's most important actions. We reduced six standing committees of the Board to three: an Audit Committee, a Compensation Committee and a Nominating and Corporate Governance Committee. The Board adopted a new requirement that any compensation program for the Chief Executive Officer must be approved by the entire Board of Directors. Any new plan or program is reviewed only in the context of the CEO's total compensation. We have developed thorough Corporate Governance Guidelines and post them on our website where they are publicly available at any time.

3) *Committee Structure*

The Nominating and Corporate Governance Committee next ensured that at least one individual who would qualify as an "audit committee financial expert," and that person would be elected to chair the audit committee. Today our Audit Committee is led by an individual who is a former investment analyst and CEO with extensive experience on numerous boards. The other members of our Audit Committee bring a diversity of perspective to their positions and have led a methodical and detailed review of each of our business lines, examining it for risk and risk controls. Our Compensation Committee is led by a member with numerous years of experience as a leader in the financial services industry, a CEO of her own company and past experience as a compensation

committee chair. Our Nominating and Corporate Governance Committee is led by a member who has over twenty years' experience as an investor in the Company. The Committee leads extensive and detailed analyses of the regulatory requirements in the corporate governance area and the use of those practices to effectively perform the oversight role the board is intended to play.

4) *Board Meetings*

Having reconfigured the composition of the Board and its committees, the Board then reconfigured the structure of its quarterly meetings. It meets over a three day period at a different company worksite each quarter so board members can see the operations and meet employees. There is a general business review attended by the board and senior management, a meeting of the independent board members without any management present and stand-alone meetings of each standing committee. The Audit Committee meets with the Company's internal and independent auditors without the presence of management. The meetings also include a general session in which one aspect of the company's business is discussed, including the internal controls associated with that business, and ends with a final session of the independent board members without management.

5) *Independent Auditor Relationship*

Together with changes to our Board's corporate governance practices in compliance with the Sarbanes-Oxley Act and our own growth and development as a company, we have closely examined our relationship with our independent auditors. We reviewed our relationship with our independent auditors to ensure they do not to perform any work for us that could jeopardize independence, such as bookkeeping services,

financial information systems design and implementation, appraisal or valuation services, actuarial services, internal audit outsourcing, management functions, human resources consulting, broker-dealer or investment banking services or expert services.

Having ensured the relationship met all definitions of independence, our Audit Committee and management team worked with Deloitte & Touche to rotate Lead Audit Partners. The Audit Committee will regularly review that relationship to determine whether to rotate external auditors.

6) *Financial Reporting Practices*

We also focused on transparency of our financial reporting. Investors had criticized our financial reporting as difficult to read and felt our reporting did not provide enough information for an investor to determine whether our business model was truly working. Over a one year period, we aggressively addressed our financial reporting practices. In accordance with Sarbanes-Oxley requirements, in 2003 we began reconciling all non-GAAP measures, such as “earnings per share from ongoing operations” with our GAAP results. Going beyond the requirements of the Act, we stopped reporting non-GAAP results such as “earnings per share from ongoing operations” altogether. We simplified the descriptions of our business and our accounting standards in our annual and quarterly financial reports so they would be more understandable for the average investor and so that financial analysts could create more accurate models of our business to provide better information to investors. Further, we identified the key metrics driving our business and began reporting our performance against those metrics on a monthly basis. We have even taken a leadership role in

establishing financial reporting standards for our sector to enable investors to compare the performance of businesses in the sector on an “apples to apples” basis.

Section 404 Implementation

At the same time we implemented these governance practices, we also prepared for the attestation of the adequacy of internal controls as required by Section 404 of the Sarbanes-Oxley Act.

The process of complying with Section 404 has been beneficial to the overall growth of our company. The process has functioned as an additional check on our existing infrastructure. The requirement that we closely identify and review all internal controls and remedy any gaps has brought additional urgency to a process that was already underway.

To comply with Section 404, we spent several months in the investigation and learning process as to both the requirements of the law and emerging best practices in implementing the law. The risk control guidelines created by the Committee of Sponsoring Organizations (“COSO”) constituted the basis of our internal control framework. We have identified approximately twenty separate entities whose processes were examined. For each of those entities, we documented the design of significant controls and focused on identifying gaps within those controls. We then defined and implemented corrective measures to tighten process gaps identified while documenting the controls. We conducted extensive testing to evaluate the design and operating effectiveness of the internal control structure. While we focused on the controls over financial reporting as required under Section 404, we also recognized that under the COSO model there is frequently an overlap between operational and compliance controls.

This process has helped us to review each set of controls and we are correcting deficiencies uncovered during the evaluation and testing process. Once this process is completed in August of this year, our independent auditors will audit our internal controls in preparation for the attestation period in early 2005. We anticipate this process will be completed by the end of this year.

Costs of Compliance

The total cost in 2004 for our Section 404 compliance program will be approximately \$4.5 million, or roughly three tenths of one percent (.3%) of our estimated annual revenues of approximately \$1.7 billion. Going forward, we expect the cost of annual compliance with Section 404 to be about one-half of the first year cost, or roughly \$2.2 million. These estimates include the cost of any consultants, as well as additional staff requirements and the time commitment of existing staff, plus the incremental costs associated with our independent auditors' attestation process.

Significant Benefits to Compliance

The process of complying with Section 404 has had many incidental and beneficial effects. It has reinforced management's understanding of accountability for processes and financial reporting across the business. It has provided management with a better understanding of various processes. We have identified necessary control design improvements and identified where processes were deficient, inconsistent or inadequate. It has allowed us to look at all internal controls across the company with a consistent approach to process controls and also strengthened internal controls between business units that had previously been overlooked. For a company at our stage of growth, the Section 404 process came at a perfect time. Our business is large enough and our

systems are mature enough to require significant internal controls and yet it is young enough that there is not institutional inertia or resistance to changing processes to implement controls.

CEO Certification

The Section 404 process is just one check in our risk control matrix. As part of the certification process required by Section 302 of the Act, we have established a Disclosure Control Committee consisting of the leaders of the organization responsible for financial reporting. Before any public filing of a financial report, that committee meets to discuss the Company's disclosures and disclosure procedures in depth. Following approval of the financial reports by the Disclosure Control Committee, all leaders of the organization certify that they have reviewed the financial report and can attest the report does not contain any untrue statement of material fact or omit to state a material fact. Each leader is given the opportunity to have a private discussion with the company's general counsel, general auditor, external counsel or external auditor to raise any issues of concern. Further, each of our employees responsible for financial reporting has been provided the contact information for each of the members of the Audit Committee of the Board. The company has established a relationship with an independent third party that provides a forum for employees to anonymously report any act they believe may be illegal or inappropriate. Any claim is promptly investigated and appropriate remedial action is taken if necessary. The Chair of the Audit Committee is directly informed of any report of improper conduct leveled against the company's senior executives, including the CEO.

Impact Of Governance Changes For Investors and Customers

Investors have unequivocally rewarded us for improving our corporate governance. As an example, in 2002, the California Public Employees Retirement System (“CalPERS”) placed E*TRADE on CalPERS’ 2003 Monitoring List. The Monitoring List is a group of companies identified by CalPERS as potentially benefiting from improvements in corporate governance. The Company worked with CalPERS and kept it closely apprised of its progress in the governance area, and in January 2004 CalPERS publicly commended E*TRADE for its corporate governance accomplishments, noting specific changes to its governance practices and also noting that the company’s stock performance in the one year period from November 29, 2002 through November 28, 2003 increased by 90.67% and outperformed its peer index by 64.38% in the period.

Our customers have also noted the impact of improved corporate governance, not just for E*TRADE but for the industry as a whole. In October 2003, just over one year after the passage of the Sarbanes-Oxley Act, we conducted our quarterly customer survey of their opinion of the markets and the economy. Asked whether they felt more confident that the information they receive as an investor is accurate, over 33 percent of our customers confirmed they were more confident in the accuracy of financial information reported by companies.

For E*TRADE, shifting the focus from corporate governance problems allowed us to return to our core strength – creating a strong and growing business that leverages our technology platform to deliver value and innovation to our customers. Since January

2003 we created and delivered a number of innovative products that directly benefit the average American investor. In June of 2003 we introduced our “portable mortgage” product allowing home buyers to lock in today’s mortgage rate and then transfer that rate to their next home purchase, potentially saving buyers thousands of dollars in interest payments in an environment of rising interest rates.

In the mutual fund arena we have made a number of important innovations. In December of 2003 we introduced a 12b-1 Fee Rebate Program. As a mutual fund distributor that has leveraged technology to lower costs, we are able to rebate half of the 12b-1 and shareholder service fees we receive to our customers, ultimately creating greater value for our mutual fund investors. The program was launched in late 2003 and the first rebates were made to our customers in June of this year. For investors in the proprietary E*TRADE Mutual Funds, we announced this June that we have cut expenses to offer an S&P 500 Index Fund, a Russell 2000 Index Fund and an International Index Fund that have the lowest expenses in the industry; in some cases as much as 75% below industry averages. At a time when investors have watched expenses rise and scandals plague the mutual fund industry, we are proud to be an innovator who champions the average investor while at the same time creating solid value for our own shareholders.

Summary

Two years following the implementation of the Sarbanes-Oxley Act, E*TRADE commends Congress for its passage. Any well-run company should embrace the principles of corporate governance the Sarbanes-Oxley Act represents. The Act provides guidance to help companies grow with good governance and provides a check for more mature companies. As companies live under the Act over time, there will undoubtedly

need to be some further modification and regulatory guidance, but we do not recommend any wholesale change of any of the Act's provisions.

Markets are cyclical, and there is no way to protect against downturns. There is also no way to completely eliminate mistakes or scandal from business. However, we can all work harder to ensure that markets are not brought down by scandal and mistakes that could be avoided by the adoption of the principles of good corporate governance and internal control represented by the Sarbanes-Oxley Act. E*TRADE Financial is proud to stand as an example of how a company can embrace good corporate governance to create value for employees, customers and shareholders.